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Legislative Bulletin……………………………………….………November 9, 2007

Contents:

Summary of the Bill Under Consideration Today:

Total Number of New Government Programs: 0

Total Cost of Discretionary Authorizations: $0

Effect on Revenue: $4.03 billion increase over ten years

Total Change in Mandatory Spending: $4.02 billion increase over ten years

Total New State & Local Government Mandates: 0

Total New Private Sector Mandates: 4

Number of *Bills* Without Committee Reports: 0

Number of *Reported* Bills that Don't Cite Specific Clauses of Constitutional Authority: 0

H.R. 3996—Temporary Tax Relief Act (*Rangel, D-NY*)

Americans for Tax Reform has indicated that it will regard a vote for this bill as a violation of its Taxpayer Protection Pledge.

Order of Business: The bill is (reportedly) scheduled to be considered on Friday, November 9th, subject to a (likely) closed rule allowing no amendments. If any changes are made to the reported bill before floor consideration, or any amendments are allowed under the rule, the RSC will provide the appropriate details in a separate document.

Summary: H.R. 3996 would impose **$82.5 billion** in permanent tax increases on businesses and individuals over ten years in order to offset temporary tax relief, such as one-year extenders of certain tax credits and deductions, and to prevent a huge, unintended tax increase by placing a one-year "patch" on the exemption level for the Alternative Minimum Tax (AMT). NOTE: Many of the provisions in this bill were taken from Rep. Rangel's Tax Reduction and Reform Act (H.R. 3920, commonly known by critics as the "Mother of All Tax Hikes"). Highlights of H.R. 3996 are as follows:

- AMT "Patch". Provides for a $66,250 AMT exemption amount for married couples in 2007 (it was $62,550 in 2006 and would drop to $45,000 without a "patch"), for a $44,350 exemption amount for singles (it was $42,500 in 2006 and would drop to $33,750 without a "patch"), and the current-law relief for nonrefundable personal AMT credits. ***Saves taxpayers $50.59 billion over ten years.***

- Incentive Stock Options. Prevents taxpayers with AMT credits from paying tax on "phantom" income attributable to incentive stock options (i.e. income that appears on paper but that the taxpayer has not actually exercised). ***Saves taxpayers $2.26 billion over ten years.***

- Standard Deduction for Real Property Taxes. Increases the standard deduction for married couples filing jointly by $700 ($350 for singles and married filing separately) for so much of the amount of state and local real property taxes paid or accrued by the taxpayer during the taxable year. ***Saves taxpayers $1.23 billion over ten years.***

- Refundable Child Tax Credit. Reduces the amount above which the portion of a taxpayer's income is refundable under the child tax credit from about $11,000 to $8,500 and eliminates any inflation adjustments. ***Increases mandatory spending by $2.87 billion over ten years.***

- One-Year Extenders. Extends the following tax credits and deductions for one year *(ten-year savings numbers indicated below because some of the one-year extenders have revenue implications beyond the first year):*
  - --State and Local Sales Tax Deduction. ***Saves taxpayers $2.34 billion over ten years.***
  - --Tuition Expenses Deduction. ***Saves taxpayers $2.47 billion over ten years.***
  - --Special Rules for Foreign Shareholders Who Invest in Regulated Investment Companies. ***Saves taxpayers $67.0 million over ten years.***
  - --Mental Health Parity. Extends for one year the $100 per day excise tax on group health plans that impose limits on mental health benefits that are not imposed on medical and surgical benefits. ***Saves taxpayers $25.0 million over ten years.*** *(Although this provision looks like a tax increase on its face, the Joint Committee on Taxation scores this as inducing group health plans to increase their mental health coverage and thus increase tax deductible health care expenditures.)*

- --Incentive to Contribute Property for Conservation Purposes. ***Saves taxpayers $52.0 million over ten years.***
- --Tax-Free IRA Distributions for Charitable Purposes. ***Saves taxpayers $452.0 million over ten years.***
- --Deduction for School Teacher Expenses. ***Saves taxpayers $204.0 million over ten years.***
- --Election to Include Combat Pay in Income for the Earned Income Tax Credit. ***Saves taxpayers $19.0 million over ten years.***
- --Special Rules for Qualified Mortgage Bonds for Veterans. ***Saves taxpayers $159.0 million over ten years.***
- --Allowance for Active Duty Reservists to Make Penalty-Free Withdrawals from Retirement Plans. ***Saves taxpayers $1.0 million over ten years.***
- --Special Rules for Non-Residents Investing in Regulated Investment Companies. ***Negligible revenue effect.***
- --Extend the treatment of Regulated Investment Companies as "qualified investment entities" under 26 U.S.C. 897. ***Saves taxpayers $10.0 million over ten years.***
- --Deeming a State Legislature as in Session on *Pro Forma* Days for Purposes of Calculating State Legislators' Travel Expenses Away from Home. ***Saves taxpayers $4.0 million over ten years.***
- --Research and Development Credit. ***Saves taxpayers $9.00 billion over ten years.***
- --Indian Employment Credit. ***Saves taxpayers $59.0 million over ten years.***
- --New Markets Credit. ***Saves taxpayers $1.32 billion over ten years.***
- --Railroad Track Maintenance Credit. ***Saves taxpayers $165.0 million over ten years.***
- --15-Year Depreciation for Leasehold and Restaurant Improvements. ***Saves taxpayers $3.47 billion over ten years.***
- --7-Year Depreciation for Motorsports Entertainment Complex Improvements. ***Saves taxpayers $27.0 million over ten years.***
- --Accelerated Depreciation for Indian Reservation Business Property. ***Saves taxpayers $148.0 million over ten years.***
- --Brownfields Expensing. ***Saves taxpayers $192.0 million over ten years.***
- --Puerto Rico Domestic Production Deduction. ***Saves taxpayers $116.0 million over ten years.***
- --Special Tax Treatment for Payments to Tax-Exempt Entities. ***Saves taxpayers $23.0 million over ten years.***
- --Qualified Zone Academy Bonds. ***Saves taxpayers $165.0 million over ten years.***
- --DC Investment Tax Incentives (such as the first-time homebuyer credit). ***Saves taxpayers $158.0 million over ten years.***
- --American Samoa Economic Development Credit. ***Saves taxpayers $16.0 million over ten years.***
- --Deduction for Contributions of Food Inventory. ***Saves taxpayers $72.0 million over ten years.***

--Deduction for Contributions of Books to Public Schools. ***Saves taxpayers $31.0 million over ten years.***
--Deduction for Corporate Contributions of Computer Equipment. ***Saves taxpayers $218.0 million over ten years.***
--Special Allowance for S Corporations Donating Property. ***Saves taxpayers $54.0 million over ten years.***
--Extension of Work Opportunity Tax Credit for Hurricane Katrina Employees. ***Saves taxpayers $21.0 million over ten years.***
--Increase in Cover-Over of Rum Excise Tax Revenues to Puerto Rico and the Virgin Islands. ***Increases mandatory spending by $93.0 million over ten years.***

- Includes the text of H.R. 3648, the Mortgage Forgiveness Debt Relief Act, as it passed the House last month. To read an RSC summary of this Act, visit this webpage: http://www.house.gov/hensarling/rsc/doc/lb_100407_mortgagetax.doc. The four main provisions of this Act, as included in H.R. 3996, score as follows:

  --Exclude Discharges of Principal Residence Acquisition Indebtedness from Gross Income: ***Saves taxpayers $1.34 billion over ten years.***
  --Extension of Deduction for Private Mortgage Insurance: ***Saves taxpayers $570 million over ten years.***
  --Alternative Tests for Qualifying as a Co-op Housing Corporation: ***Saves taxpayers $21 million over ten years.***
  --Reduction of Gain on Sale of Secondary Residence: ***Costs taxpayers $1.99 billion over ten years.***

- Includes the text of H.R. 3056, the Tax Collection Responsibility Act, almost identically to how it passed the House last month. To read an RSC summary of this Act, visit this webpage: http://www.house.gov/hensarling/rsc/doc/lb_101007_taxcollectors.doc. The main provisions of this Act, as included in H.R. 3996, score as follows:

  --Repeal of Private Debt Collection Contract Authority: ***Increases mandatory spending by $1.05 billion over ten years.***
  --Delayed Implementation of Government Withholding: ***Saves taxpayers $44 million over ten years.***
  --Application of Statute of Limitations Rules to Persons Claiming Virgin Island Residency: ***Saves taxpayers $38 million over ten years.***
  --Revision of Tax Rules on Expatriation: ***Costs taxpayers $730 million over ten years.***
  --Repeal of Suspension of Certain Interest and Penalties When IRS Fails to Contact Taxpayer: ***Costs taxpayers $128 million over ten years.***

- Deferred Compensation. Prevents hedge fund managers from using foreign corporations to defer taxes on compensation. Thus, deferred compensation would be taxed as it accrues, rather than when it's actually paid. Current law generally allows executives and other employees to defer paying taxes on compensation until the compensation is paid. ***Costs taxpayers $23.85 billion over ten years.***

- <u>Carried Interest</u>. Requires investment fund managers to treat carried interest as ordinary income (and thus be taxed at a higher rate). Currently, carried interest is taxed at the capital gains rate, since carried interest is a capital gain. Carried interest is the name given to the compensation that fund managers earn based on the performance of the fund which they manage. This compensation is the main performance incentive driving fund managers to do better—but such compensation only comes from capital gains. It is by no means “ordinary” income. In fact, this capital gain revenue is already subject to the 35 percent <u>corporate</u> tax rate before it is distributed to investors as capital gains or dividends, meaning that it is already double-taxed when the manager receives it, even at the 15 percent capital gains rate. ***Costs taxpayers $25.59 billion over ten years.***

- <u>Unrelated Business Income Tax</u>. Allows pension plans, universities, and other tax-exempt entities to directly invest in hedge funds and other investment funds without triggering the unrelated business income tax. ***Saves taxpayers $1.34 billion over ten years.***

- <u>Gains from Related People</u>. Treats the gain on sales between related parties as ordinary income (not as capital gains with its lower tax rates). ***Costs taxpayers $135.0 million over ten years.***

- <u>Worldwide Allocation of Interest</u>. Delays by nine years the implementation of the provision allowing U.S. corporations to elect special interest allocation rules for foreign assets (used when determining the foreign income tax credit). ***Costs taxpayers $26.21 billion over ten years.***

- <u>Cost Basis Reporting</u>. Mandates cost basis reporting by brokers for transactions involving publicly traded securities, beginning on securities acquired in 2009 (and on all other financial instruments acquired in 2011 and thereafter). ***Costs taxpayers $3.37 billion over ten years.***

- <u>Failure-to-File Penalty Increases</u>. Increases the present-law failure-to-file penalty for partnership returns by $25 per partner times the number of shareholders in the partnership during any part of the taxable year for which the return was required, for each month (or a fraction of a month) during which the failure continues, up to a maximum of 12 months. The bill also establishes for S Corporations a new penalty with the same structure as the increase for partnerships. ***Costs taxpayers $507 million over ten years.***

- <u>Estimated Corporate Tax Payments</u>. Increases the estimated tax payments that certain corporations must remit to the federal government. Under current law, corporations with assets of at least $1 billion must make estimated tax payments for the third quarter of 2012 that are 115% of the estimated payment otherwise due. The payment due for the fourth quarter of 2012 is reduced accordingly so that the corporations pay no net increase in estimated payments in 2012. H.R. 3996 would increase this 115% figure to 181%. This large increase would force applicable companies to increase their estimated payments by **$39.6 billion** in the last quarter of FY2012 (though they would be offset by a corresponding reduction in the subsequent quarter). **<u>NOTE</u>:** This provision is merely a revenue timing shift, a budget gimmick used to comply with the House's PAYGO rules and has no net budget effect over ten years. Without this gimmick, the bill would fail the PAYGO test for the five-year period.

Additional Background: The AMT was created in 1969 as a mandatory add-on to the existing tax code to prevent 155 of the very wealthiest taxpayers from lowering their tax bills using the available deductions and credits. The AMT's reach has since grown dramatically through bracket creep.

The AMT has a two-tiered rate structure, 26% and 28%, and an exemption, so that most people do not currently pay the AMT (which is always a higher tax than the tax calculated under the regular tax system).

Unlike other exemptions in the tax code, the AMT exemption (currently $45,000 for joint returns in tax-year 2007) is not adjusted for inflation. As a result, though meant for the wealthiest of taxpayers, 3.5 million taxpayers were subject to the AMT in 2006, and tax organizations estimate that **23 million taxpayers may be subject to the AMT in 2007**.

Another important reason the AMT is negatively impacting more and more taxpayers is the 1993 tax increase, written by a Democrat Congress and signed into law by President Clinton. The Democrats raised the then-24% rate to 26% on the first $175,000 of AMT-taxable income above the exemption and 28% on the AMT-taxable income in excess of $175,000.

RSC Bonus Fact: In 1999, the Republican Congress sent legislation to the President fully repealing the AMT, yet President Clinton vetoed that bill.

Committee Action: On October 30, 2007, the bill was referred to the Ways & Means Committee, which, on November 2nd, marked up and ordered it referred to the full House by a vote of 22-13.

Possible Conservative Concerns: Consensus is building around the need to repeal, not just "patch" for one year, the AMT for individuals, which is a mandatory recalculation of the tax bill of certain taxpayers that always leads to higher taxes for these taxpayers. Repealing the AMT would save taxpayers billions of dollars immediately and thereafter.

One significant point of controversy is whether the repeal of the AMT should be "offset" by tax increases or spending cuts elsewhere. In short, the offset approach is based on the notion that the government *is entitled to* the increasingly higher tax revenues from the AMT (even though these higher revenues were never intended to be collected). That is, this approach is based on the philosophy that the correction of tax mistakes should be offset with tax increases so that there is no net loss of revenue to the federal government, even if the tax increases apply to different people than do the tax mistakes. The offset approach takes a government-first perspective; it views revenues from the vantage point of the federal government, rather than from the individual taxpayer.

Most conservatives have grave concerns with the offset approach, i.e. the tax-increase approach, and thus with the legislation summarized above, since it offsets <u>temporary</u> tax relief with <u>permanent</u> tax increases.

Most conservatives believe on principle that no tax relief, especially income tax relief, *needs* to be offset, since tax relief is savings to taxpayers. Most tax relief allows taxpayers to keep more of their own money; it does not "cost" the government anything. If, however, tax relief must be offset, it should be offset with spending reductions, not tax increases.

Most conservatives would argue that the principled opposition to offsetting tax relief *especially* applies in instances where the tax relief is being provided to correct a mistake or oversight by the federal government, as it does in the case of the AMT. The correction of tax mistakes applicable to one set of people should never be offset with tax increases on a different set of people, as would be the case under H.R. 3996. That is, most conservatives believe that it is improper for the federal government to punish some people and businesses with higher taxes just because the federal government unintentionally increased taxes on other people.

Under current law, the Congressional Budget Office projects that federal revenues will increase faster than economic growth. In other words, the tax burden (measured as a percentage of Gross Domestic Product) is expected to increase. This would still be true, just to a smaller extent, if the AMT were reduced or even eliminated. Thus, the only rationale for "paying" for an AMT reduction with any offsetting tax increase is the belief that the tax burden *should be <u>higher</u>* than it currently is or than what it has historically been. Conservatives believe in a lower tax burden for all Americans.

Many conservatives have expressed strong objections to some of the particular tax increases and other provisions included in H.R. 3996, including, but not limited to (in no particular order):

- <u>Carried Interest</u>: "Carried interest" is just another phrase for gains made from investments. It is by no means "ordinary" income since it is incentive compensation based solely on capital gains that may or may not be realized. Should capital gains not be taxed at the capital gains rate? Changing the carried interest taxation rates would both remove a huge incentive for investment fund managers to make their funds more profitable to investors and force partners to offer high pre-tax compensation to fund managers, thereby lowering returns for millions of investors who rely on capital gains or dividend income.

- <u>One-Year Extenders</u>: Many tax deductions and credits that conservatives support, such as the research and development tax credit and the mortgage insurance deduction, would be extended for just one year, whereas the tax increases in the bill would be permanent. This inequity demonstrates a preference for tax increases over tax relief.

- <u>Refundable Child Tax Credits</u>: The refundable child tax credit would be greatly expanded by this bill. Many conservatives regard refundable tax credits as spending through the tax code, no different than a direct appropriation from the Treasury to individuals who have not paid taxes that year. Many conservatives may see this refundable credit expansion as particularly offensive in this legislation, since it is paired with numerous provisions increasing taxes on businesses and people that do have net tax liabilities.

- Marriage Penalty: The AMT "patch" contains a large marriage penalty (since the exemption for married couples filing jointly is not double that for singles).

- Capital Gains Reduction for Second Homes. Some conservatives have expressed concerns about the capital gains exclusion provision of this bill (same as in H.R. 3648), not only because that provision yields a $2 billion tax increase over ten years, but because it could harm real estate markets that are heavily dependent on non-primary residences (such as coastal communities and retirement communities) and would target entrepreneurs who own rental properties. Some conservatives have deemed the tax increase in this bill as "a permanent luxury tax on second homes" and compare it to the failure of the luxury tax on yachts (which was repealed after harmful unintended consequences became evident).

- IRS Collection Activities. Some conservatives have expressed concerns about the provision (same as in H.R. 3056) that would eliminate a successful program that the IRS has used to collect smaller tax-debts, debts that the IRS has said it would not otherwise make sense (from a cost perspective) to go after. Additionally, some conservatives may be concerned at the goal of limiting the ability for the federal government to use private contractors.

- Timing Shift Budget Gimmick. Some conservatives may be concerned that the corporate estimated tax payments timing shift (a budget gimmick for complying with PAYGO rules on paper) is quite large in this legislation (usually the payment shift is much smaller), forcing some companies to pay nearly double their normal estimated tax payment for the fourth quarter of fiscal year 2012 ($39.6 billion in shifted payments). American businesses should not be forced to come up with this much extra money in a quarter to remit to the federal government just because of Congress' desire for budget gimmickry.

Administration Position: The Statement of Administration Policy (SAP) notes that, "the Administration does not believe the appropriate way to protect 21 million additional taxpayers from 2007 AMT liability is to impose a tax increase on other taxpayers. Accordingly, if H.R. 3996 were presented to the President in its current form, the President's senior advisors would recommend he veto the bill."

Cost to Taxpayers: The separate cost and revenue estimates for H.R. 3996 by the Joint Committee on Taxation (JCT) and the Congressional Budget Office (CBO) do not match up perfectly. For the purposes of this Legislative Bulletin, RSC staff used the figures produced by JCT, yet used CBO as a guide to determine which of the JCT revenue figures actually score as mandatory spending. Given this methodology, H.R. 3996 would have the following implications on:

Revenues:

- $52.383 billion decrease in FY2008;
- $3.642 billion increase over the FY2008-FY2012 period; and
- $4.025 billion increase over the FY2008-FY2017 period.

Mandatory Spending:

- $108 million increase in FY2008;
- $3.435 billion increase over the FY2008-FY2012 period; and
- $4.015 billion increase over the FY2008-FY2017 period.

Does the Bill Expand the Size and Scope of the Federal Government?: The bill would permanently increase taxes on some businesses and individuals and temporarily offer tax relief to others.

Does the Bill Contain Any New State-Government, Local-Government, or Private-Sector Mandates?: According to the Joint Committee on Taxation and CBO, the bill contains no intergovernmental mandates and four private-sector mandates within the meaning of Public Law No. 104-4, the Unfunded Mandates Reform Act of 1995:

- denying of some of the capital gains on sale of a secondary residence;
- treating the "carried interest" income of partners for performing investment management services as ordinary income;
- delaying the application of the worldwide allocation of interest expense; and
- requiring brokers to report customers' bases in securities transactions.

Does the Bill Comply with House Rules Regarding Earmarks/Limited Tax Benefits/Limited Tariff Benefits?: The Ways & Means Committee, in House Report 110-431, asserts that, "Pursuant to clause 9 of rule XXI of the Rules of the House of Representatives, the Ways and Means Committee has determined that the bill as reported contains no congressional earmarks, limited tax benefits, or limited tariff benefits within the meaning of that rule."

Constitutional Authority: The Ways & Means Committee, in House Report 110-431, cites constitutional authority in Article I, Section 8, Clause 1 (the congressional power to lay and collect taxes, duties, imposts, and excises to pay the debts and provide for the common defense and general welfare of the United States) and the 16th Amendment (the congressional power to tax incomes).

Outside Organizations: Opponents of the legislation at press time include, at a minimum:

- American Conservative Union;
- Americans for Prosperity;
- Americans for Tax Reform ;
- FreedomWorks; and
- National Taxpayers Union.

Americans for Tax Reform has indicated that it will regard a vote for this bill as a violation of its Taxpayer Protection Pledge.

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